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FINANCING GROWTH-RELATED CAPITAL NEEDS



Ontario Ministry of Treasury and Economics

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RECORDS MANAGEMENT DIVISION

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FINANCING GROWTH-RELATED CAPITAL NEEDS

I. INTRODUCTION

Parts of Ontario are experiencing rapid growth. This growth has placed much pressure on the Province, municipalities and school boards to expand services and related capital infrastructure such as sewer, water and road systems, public transportation and schools. The various demands on the Province limit its ability to address these needs on its own. New ways to help finance capital infrastructure must be explored.

For example, in 1984-85, the Province provided \$72.1 million for education capital. Since that time, Provincial support for school related capital has increased more than 300 per cent. In the May, 1988 Budget, the Province made a commitment to provide \$300 million annually for the next three years for education capital. Of that amount, 91 per cent of the 1988 allocation went to growth-related projects. There are approximately 6800 portable classrooms in Ontario which should be replaced by new school buildings or additions.

Ontarians also have a \$17 billion investment in aging school capital facilities. If steps are not taken to address the needed renovation of these facilities, the public is in danger of losing this investment.

This paper outlines some proposed directions to finance growth-related capital needs in the province. The paper examines lot levies and other means of financing capital expenditures. It also provides suggestions for improving the structure and accountability of existing municipal lot levies and front-end financing.

An interministerial committee including representatives from Municipal Affairs, Treasury and Economics, Education and Housing has been established. Briefs outlining suggestions on proposed directions and/or suggestions for alternative methods of financing capital expenditures, should be forwarded to the Interministerial Committee on Financing Growth-Related Capital Needs, by March 1, 1989.

Objectives

The objectives for financing capital growth are to:

- . provide structure and accountability for existing municipal lot levies;
- . ensure a uniform approach to municipal front-end financing;
- . accelerate the rate of school capital construction to reduce the backlog and accommodate new growth;
- . provide increased responsibility for capital to school boards by moving their share from the current 25 per cent to 40 per cent on average, coupled with new revenue sources and financing options;


- . support the Provincial policy on affordable housing;
- . ensure that new development shoulder some of the burden of the capital costs associated with that growth; and
- . provide flexibility in financing arrangements.

Possible Approach

1. Enable municipalities to use lot levies to recover from the various classes of residential, commercial and industrial property **up to** 100 per cent of net growth-related capital costs.
2. Enable school boards to use lot levies to recover from the various classes of residential property **up to** 100 per cent of net growth-related capital costs (i.e., new pupil places).
3. Limit the municipal and education levies on affordable houses to a **maximum** of 60 per cent of the levies on other houses.
4. Lever a greater amount of school construction from current Provincial grant levels by decreasing the average Provincial rate of support on approved school capital from 75 per cent to 60 per cent.
5. Reduce school board borrowing costs, particularly for smaller school boards, by providing them with access to Canada Pension Plan funds for approved capital projects. Priority access would be given to those boards facing the highest borrowing costs. The existing policy, allowing the use of debentures for capital needs, will be maintained.
6. Encourage boards to pursue alternative means of financing. Boards could negotiate with developers to provide payment in kind (e.g., facilities or land) **instead of** paying lot levies.
7. Provide legislative authority for municipalities to establish front-end financing arrangements at their discretion, and to reimburse developers for building oversized sewer, water and road services.

Legislative Implications

A Development Charges Act would be required to provide the authority for municipalities to establish and adopt lot levy by-laws for their own purposes and for school board purposes. Lot levies would be introduced **at the option** of the municipality or school board, the school board doing so by way of a request to a municipality. All lot levy by-laws would be subject to appeal at the Ontario Municipal Board. The Act would also be required to provide the authority for municipalities to establish front-end financing arrangements.



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Timing of Implementation

The Government plans to introduce legislation to implement a strategy during the next session of the Legislature. The timing of implementation, including whether legislation should be effective from introduction of the Bill or on Royal Assent, is subject to consultation. Until a Bill is introduced, municipalities are asked to hold lot levies at their current levels to provide certainty to all parties.

II. MUNICIPAL LOT LEVIES

The Establishment of Municipal Lot Levy By-Laws

Some municipalities have introduced lot levies. The current system has been ad hoc in nature. Municipalities have faced uncertainty with respect to their legal authority to impose lot levies. In addition, the methods used to introduce, set and amend lot levies have varied considerably. This has caused confusion for developers and builders.

A number of suggestions for improving the structure and accountability of municipal lot levies are outlined below.

Certainty

In the interest of certainty and stability, an unamended by-law should have a duration no longer than five years. To remain in force after five years, a new by-law must be enacted to give the municipality legal authority to collect lot levies.

Right of Appeal

The Ontario Municipal Board (OMB) has been the avenue of appeal for the developer who fails to reach an acceptable agreement with the municipality. When a developer appeals, the municipality can prevent the developer from proceeding with the proposed subdivision until the OMB has made a decision. While many developers have chosen this route in the past, it is both time consuming and costly. Smaller developers may not have the resources to mount an effective appeal. Consequently, appeals are not always a practical alternative.

Under the proposed system of appealing lot levy by-laws, anyone who disagreed with the by-law could appeal to the OMB within 20 days of its adoption. The OMB would have the authority to alter the lot levy amount, based on evidence presented. This would ensure that the municipality prepares its case thoughtfully and thoroughly with regard to the intent of the legislated framework. Once the appeal period had elapsed, no further appeals would be permitted, with the exception of appeals on by-law amendments, until a new by-law has been established.

During an appeal, developers could proceed with construction without delay, by paying the lot levy set out in the by-law. Any amounts in excess of those allowed by the OMB would be refunded with interest.

Phase-In Provisions

The concept of a phase-in period for new lot levy by-laws has been unanimously supported by the Urban Development Institute, the Ontario Home Builders' Association and the Association of Municipalities of Ontario. A maximum of one year would be granted for municipalities' by-laws to conform with the legislation. In the interim, the existing lot levy policy would be in effect. After the phase-in period, no lot levy charges could be collected until a new lot levy by-law was adopted.

Eligible Cost

Municipalities would be permitted to recover up to 100 per cent of the growth related capital costs of all services (both hard, e.g. sewers, and soft, e.g. arenas). It is proposed that capital would be defined as land, buildings and associated financing and acquisition costs. Capital would not include expenditures required to maintain the ongoing operations of the facility or to acquire rolling stock, furniture, fixtures or equipment. This definition of capital cost is simple and verifiable by the OMB. It has been estimated that these capital costs represent 80 to 90 per cent of the total cost of establishing most new municipal service facilities.

In the determination of the capital cost for each facility, the municipality would calculate the present value of the capital expenditure, net of any government grants, previous contributions and any and all reserves specifically earmarked for that capital expenditure.

Methods of Calculating Lot Levy Charges

On December 19, 1985, in response to the petition to Cabinet on the OMB decision regarding Mod-Aire v. Bradford, 1984, Cabinet issued the following guidelines.

- a) It is within the power of a municipality to establish uniform lot levies, provided that there is a reasonable relationship between the proposed levies and the overall costs to the municipality attributable to growth with respect to the services covered by the levies; and
- b) There need not be a direct relationship between the additional cost incurred by the municipality and the utilization of any given service that is the subject of the levy. A lot levy may be a combination of a uniform levy for average costed services and any additional amounts for other services financed as directly attributable to the subdivision proposed to be charged.

The primary rationale for introducing a lot levy is that a municipal council should be able to require new development to pay the capital costs associated with servicing growth. Therefore, only those capital expenditures incurred or expected to be incurred by the municipality within a reasonable time frame, that specifically serve or benefit new development, would be included in the determination of the lot levy charge.

Municipalities that have no existing lot levy policy or have a relatively insignificant one, and that have outstanding capital commitments attributable to recent growth, would not include any amounts related to previous development in lot levy calculations.

There are two commonly used methods in which to measure service level standards. The first method is by quantity per population or per number of households. The second method is by quality standards which relate to the cost per facility based on the existing programming requirements. Methods would be described in detail in the guidelines to be provided by the Government.

Credit for Works Constructed by Developers

A developer may be required by the municipality to construct external capital facilities in order for a particular development to proceed. These works may form part of the overall municipal service system, be installed with the consent or at the request of the municipality and be included in determining the lot levy charge. If so, the developer should receive credit against the lot levies. Developers who are dissatisfied with the compensation may appeal to the OMB with all pertinent information.

Indexation of Levies

Municipalities would be permitted to increase their lot levy charges on an annual or semi-annual basis in accordance with the Southam Construction Price Index or any other index. This would ensure that lot levy charges keep abreast of inflation for the years between reviews.

Timing of Payments

Lot levy charges would be payable by the developer when the building permit is granted. This is adequate for municipal funding requirements because the majority of the services financed by the lot levy (with the possible exception of roads, sewer and water costs) are installed after much of the growth has occurred. Municipalities and developers may agree to prepayment of a portion of the levies to facilitate the early construction

of major works. Corresponding adjustments would be made to the final levy amounts. Conversely municipalities could choose to allow developers to pay at a later date, such as when the first lots are sold.

Collection of Upper Tier Levies

All development must be processed through the lower tier. It would be reasonable if the responsibility for collection for all local governments rested with the lower tier. The upper tier's lot levy would be credited to its account within 90 days of collection, unless an extension was agreed to by the upper tier.

If an upper tier believes that special circumstances warrant collecting part of its levy at an earlier or later stage of development, the responsibility for negotiating an acceptable agreement with the developer rests solely with the upper tier.

Classes of Development

Municipal lot levies might be charged on commercial and industrial as well as residential development, subject to the requirement that the levies charged against commercial and industrial or residential development only recover the growth-related capital costs of that particular class.

Accounting and Disclosure Requirements

There is strong support for the concept of full accountability with respect to the accumulation and utilization of lot levy receipts.

A municipality that adopts a lot levy by-law should establish, as a minimum, one reserve fund to account for all lot levy receipts. In addition, the Treasurer of each municipality should submit annually to the Council of the municipality, a statement of continuity for each reserve fund established for the year ended December 31st.

Each statement of reserve fund continuity would include an addendum which indicates, on a project-by-project basis, the intended application of the amounts transferred to the capital fund. Municipalities would be obliged to inform all new homebuyers in areas subject to lot levies, of the levy amounts and their intended uses. This would further enhance the accountability of the municipality. Where lot levy funds initially transferred to the capital fund are reallocated during the year to a project that is functionally different, this realignment should also be noted. The intent is that each municipality would institute an internal structure of accountability that would readily permit it to respond to concerns that might be subsequently raised regarding the application or appropriateness of the lot levies imposed.

III. SCHOOL PURPOSE LOT LEVIES

Authority

School purpose lot levies would require establishment in legislation and follow a similar process to that governing the municipal lot levy.

Like municipalities, school boards would have discretionary authority to implement an educational lot levy. The public consultation process used to ensure accountability would be similar to that established for municipal lot levies. If a school board chose to implement a school purpose lot levy, after consultation, it would have to pass a resolution to that effect requesting the municipality(s) to collect the levies. The municipality would then enact the school board lot levy by-law.

School boards' lot levies could fund all or part of the growth-related capital costs, net of Provincial grants, for school capital projects approved by the Ministry of Education. The appeals process would parallel that for municipalities.

Lot Levy Collection and Trust Account

The levy would be paid by the developer or builder to the local municipality when the building permit is issued and the funds would be transferred to a joint account held in trust by the co-terminous school boards.

The Ministry of Education would authorize payments out of the trust account at the time of final approval of the capital project(s) for which the levies were imposed.

Method of Calculation

Information from the Multi-Year Capital Expenditure Forecast on projected school needs for growth would be used to determine projects eligible for education lot levies. Projected housing starts for the next five years in each municipality would be determined for the school boards' jurisdiction. The Board could opt to designate areas as non-growth areas and therefore exempt them from the lot levy. The school boards and the Ministry would determine the physical facilities and lands required to best service the growth. Existing Ministry guidelines and practices regarding eligibility of pupil places to receive grants would continue. The approved cost of the facilities, based upon the Ministry of Education Capital Grant Plan, would be calculated.

The school board's rate of grant would be applied against the approved cost. The difference between the approved cost and the Provincial grant would be eligible for inclusion in the education lot levy calculation.

Public Input

Once the education lot levy has been determined, and prior to the passing of the Board's resolution, each school board intending to establish a school purpose lot levy would, as a minimum, hold one meeting to inform the public about the determination of the lot levy charge and its application.

By-Law Process

In the event that at least one of the co-terminous school boards wished to implement an educational lot levy, that board would request the appropriate municipalities, by resolution, to adopt an education lot levy by-law, stating the amounts to be levied on all new residential development and remitted to a joint trust fund. It would be in the interest of the other co-terminous board to participate in the lot levy process, otherwise its ratepayers would pay all of the local share through their property taxes.

1. The by-law would be in force for a period of up to five years.
2. Appeals to the OMB would be allowed on the original lot levy by-laws during the allotted 20 day period.
3. If an appeal were requested, the OMB would be given the power to alter the lot levy charges proposed in the lot levy by-laws on the basis of the evidence presented.
4. School boards, like municipalities, would be permitted to index lot levy charges on an annual or semi-annual basis.
5. The collection of school board lot levy charges would be the responsibility of the lower tier municipality and, unless agreed to by the school board, the full amount of the education lot levy receipts would be forwarded within 90 days after the levies were paid.
6. Once a municipality adopted an education lot levy by-law, a joint trust account would be established by the participating co-terminous school boards. The utilization of the trust fund would be subject to the approval of the Ministry of Education.
7. Each year, the participating school boards would account for the status and utilization of the trust fund. The participating school boards would publish annually, as part of their financial statements, a statement of continuity for the trust fund for the year ended December 31.
8. Each trust fund continuity statement prepared would include an addendum which would indicate on a project-by-project basis, the application of the amounts transferred.

9. The amount of the lot levy would be provided to prospective home buyers for their information.

IV. TREATMENT OF AFFORDABLE HOUSING

In keeping with the Province's commitment to affordable housing, the lot levies on such homes would be capped at a **maximum** of 60 per cent of the levies on other housing. Definitions of affordable housing will be forthcoming in the Government's policy statement on housing. The draft policy statement is currently out for public consultation.

The expected revenues from lot levies would in no case exceed 100 per cent of the net growth-related capital costs at the projected mix of affordable and other housing in the jurisdiction.

The levels of each levy would be determined by the jurisdiction (upper or lower tier, school board) imposing the levies.

V. PROVINCIAL SUPPORT FOR SCHOOL CAPITAL CONSTRUCTION

In order to increase the amount of school construction, the Provincial rate of support on approved school construction costs would be reduced from the current average rate of 75 per cent to an average of 60 per cent. Thus, the Province's three-year commitment of \$300 million per year would lever \$500 million per year in approved school construction, up from the current \$400 million. This would have the effect of increasing the local share to 40 per cent on average. School board lot levies would partially or fully offset this, and the impact on education-purpose mill rates would be minimized.

School projects, including the backlog, that are not subject to the lot levy provision would continue to be funded through a combination of Provincial grants and school-purpose property taxes.

VI. ACCESS TO CANADA PENSION PLAN FUNDS FOR SCHOOL BOARDS

Canada Pension Plan (CPP) funds loaned to the Province would be made available to permit school boards to borrow at near Government of Canada rates.

This would reduce the debt service and administrative costs of borrowing, particularly for the smaller boards, thus minimizing the impact of school construction on school-purpose mill rates.

CPP funds are available to the Province in the form of a 20-year loan with all principal due at maturity. Interest is payable semi-annually at a rate based on the Federal bond rate (generally the lowest rate available for a 20-year term).

Since some large school boards can borrow in the market at close to Provincial rates, they should probably not be permitted to crowd out smaller borrowers who would be required to pay higher rates. A queuing strategy would offer available funds first to the smaller borrowers with the greater expansion requirements.

The balloon payment of principal at maturity is not a desirable feature of CPP financing. Annual principal payments are frequently considered to be more suitable. A school board could put the difference between the annual servicing costs of the two types of loan into a sinking fund. However, if the school board were unable to achieve a rate comparable to the CPP rate on sinking fund money, additional funds would be required to meet the final payment.

School boards would retain their right to borrow from conventional sources to finance capital growth.

VII. PAYMENTS IN KIND AS AN ALTERNATIVE TO LOT LEVIES

In some circumstances, developers may prefer to offer land or other payments in kind, as an alternative to lot levies. This should be encouraged, subject to the condition that construction standards are met.

VIII. FRONT-END FINANCING ARRANGEMENTS FOR MUNICIPALITIES AND DEVELOPERS

A long standing issue with the development industry has been the reimbursement of front-end financing. Developers often provide or pay up-front for facilities beyond the requirements of a particular subdivision. The facilities have normally included only major infrastructure such as sewer, water and road works. A common excess requirement is an oversized sewer pipe within a subdivision or the extension of a pipe past undeveloped parcels to connect a subdivision.

Many municipalities have established policies of providing credit to developers for oversizing on-site works. In the case of major off-site facilities, some have agreed to reimburse the initial developer by levies collected from subsequent developers. Generally, this is under a "best efforts" clause in the subdivision agreement. The municipality is only obligated to pay if and when the money is collected.

By entering this type of agreement, the developer is assuming some risk. Subsequent development may occur at a much slower rate than projected or may not take place at all. The municipality may fail to collect from the later developments because of uncertainty surrounding lot levies. In addition, developers may or may not be assured of receiving interest on substantial sums of money which may be tied up for extended periods of time.

Since the legality of this issue has never been clear, the development industry has pressed for express municipal authority for front-ending reimbursement. Legislation would be required to clarify a municipality's ability to levy, collect and refund charges of this nature. Such legislation could be introduced and integrated with any general lot levy legislation which would be permissive. Front-end financing arrangements would be confirmed for sewer, water and road services, as they currently exist. A key element would be the authority to demand payment from subsequent developers. The obligation to reimburse would still be conditional on receipt of the revenues.

Under a front-ending agreement, the municipality would either leave the particular capital work(s) in its lot levy calculations and agree to repay the initial developer from subsequent lot levy collections or remove the capital work(s) from its lot levy calculation. In this case, the system-wide lot levy would be reduced and a benefitting area for the capital work(s) would be established. Additional charges would be collected from future development within that area and refunded to the initial developer.

In light of this, a municipality would have the authority to define the lands which may benefit from the construction of the "front-end" capital facility. The municipality would calculate a unit charge to recover the appropriate share of the costs refundable to the initial developer. The agreement establishing the benefitting area and unit charge would also include a provision to adjust the unit charge over time, in conjunction with a generally available construction cost index. This is consistent with the philosophy inherent in the lot levy framework and would ensure that the initial developer receives a fair refund. Front-end payments could be made in money or by the provision of services or facilities in lieu of money.

The municipality would be required to give notice of the front-ending agreement to all owners within the benefitting area, explaining the nature and purpose of the agreement. The agreement would be available in the municipal offices for viewing during normal business hours. Any owner, except a party to the agreement, could object to the agreement by notifying the municipality in writing within an allotted period of time.

If no objection was received within that time, the agreement would be deemed to have come into force. If there were objections, the municipality would pass the objection to the Ontario Municipal Board, which would hold a hearing to decide the issue.

The municipality would place all monies received from the parties to an agreement in a special account, and would use the funds only for the purposes for which they were collected. Further, the municipality would provide annually to the parties of the front-ending agreement a statement indicating the payments that had been made to or from the account, the account balance and any further payments, if any, required from the parties pursuant to

the agreement. If the municipality failed to collect the agreed-to amounts from subsequent developers, the front-ending developer would have the right to appeal to the OMB and the Board could compel the municipality to reimburse the front-ending developer.

Briefs should be sent to:

Interministerial Committee on Financing
Growth-Related Capital Needs
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